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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1935

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# No. 12

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AMERICAN SURETY COMPANY OF NEW YORK,
A CORPORATION,
*Petitioner,*

*vs.*

WESTINGHOUSE ELECTRIC MANUFACTURING COMPANY, A CORPORATION, ET AL.

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## BRIEF FOR THE PETITIONER.

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# INDEX.

## Subject Index.


| | Page |
|---|---|
| Opinions of the Court Below | 1 |
| Jurisdiction | 1 |
| Statement of Facts | 2 |
| Questions Presented | 4 |
| Specification of Errors | 4 |
| Summary of Argument | 5 |
| Argument | 6 |
| Point I. The Surety is entitled to the reserved fund | 6 |
| A. The Surety has a direct right to the fund | 6 |
| 1. By the law of indemnity the Surety has a direct right to the reserved fund | 6 |
| 2. The Surety has an implied right of indemnity, even though there be no express contract creating such a right | 8 |
| 3. An express contract of indemnity does not detract from the Surety's implied right of indemnity | 9 |
| 4. The Surety has a greater right to the reserved fund under principles of indemnity than it has by the law of subrogation | 10 |
| 5. The Surety's right of indemnity to the reserved fund attached at the time the contract of indemnity was executed | 13 |
| 6. The Surety has an equitable lien on the reserved fund | 18 |
| B. Equitable principles analagous to subrogation demand that the Surety should have the reserved Fund | 20 |
| C. Payment of the retained fund to the materialman would constitute an impairment of the Surety's rights under the original contract | 29 |
| Point II. The materialman have only a general creditor's claim to the reserved fund | 31 |
| A. The materialmen have no equitable lien on the fund | 31 |
| 1. No express contract gives materialmen an equitable lien on the fund in question | 32 |
| 2. The materialmen have no equitable lien by reason of any statute or statutes | 32 |
| 3. There is no basic reason for implying an equitable lien on the retained fund | 41 |

Page

4. A discretionary retention of funds does not establish an equitable lien for materialmen on such funds ..... ..

Point III. If the Surety is denied a preferred claim, it, nevertheless, has a general creditor's claim and would share ratably with the materialmen and other general creditors ..... 48

Conclusion ..... 49

TABLE OF AUTHORITIES.

*Cases.*

Page

Alfred Richards Co. v. Rothwell, 18 App. D. C. 516 (1901) ..... 38, 47

American Bank and Trust Co. v. Langston, 180 Ark. 643, 22 S. W. (2d) 381 (1929) ..... 46

In re American Product Co., 224 Fed. 401 (C. C. A., 3rd, 1915); appeal dismissed, 239 U. S. 637, 60 L. Ed. 480 (1916) ..... 25

American Surety Co. v. Finletter, 274 Fed. 152 (C. C. A., 3rd, 1921) 16

American Surety Co. v. National Bank, 17 F. (2d) 942 (D. C. S. D. Ohio, 1925) ..... 14

Barnes v. Alexander, 232 U. S. 117, 121, 58 L. Ed. 530 (1914) .... 10

Beiknap Hardware Co. v. Ohio River Contract Co., 271 Fed. 144 (C. C. A., 6th, 1921) ..... 36

Bullock v. Campbell, 9 Gill (Md.) 182 (1850) ..... 13

Cole v. Myers, 100 Nebr. 480, 160 N. W. 894 (1916) ..... 49

Columbia Brick Co. v. D. C., 1 App. D. C. 351 (1893) ..... 36

Crown Lumber Co., Ltd., v. Smythe (1923), 3 D. L. R. 33 ..... 22

In re Dailey, 19 F. (2d) 95 (D. C. D. N. J., 1926) ..... 8

Derby v. U. S. F. & G. Co., 87 Oreg. 34, 169 Pac. 500 (1917) ..... 46

Dupont, etc., Co. v. City of Glenwood Springs, 19 F. (2d) 225 (C. C. A., 8th, 1927) ..... 36

Equitable Surety Co. v. U. S., 234 U. S. 448, 58 L. Ed. 1394 (1914).. 40

First National Bank v. City Trust, etc., Co., 114 Fed. 529 (C. C. A. 9th, 1902) ..... 23

First National Bank v. Pesha, 99 Neb. 785, 157 N. W. 924 (1916).... 22

Ford v. Strowbridge, Nelson Ch. 24 (1633) ..... 8

In re Fowble, 213 Fed. 676 (D. C. D. Md., 1914)..... 32, 40, 41

Freeny v. Bauernschmidt, 33 F. (2d) 709 (C. C. A. 4th, 1929)..... 40

Globe Indemnity Co. v. Unity Railways Co., 272 Fed. 607 (C. C. A. 3rd, 1921) ..... 8

Griffin v. Long, 96 Ark. 268, 131 S. W. 672 (1910)..... 14

Hackensack Brick Co. v. Borough of Bogota, 86 N. J. Eq. 143, 97 Atl. 725 (1916) ..... 22

Hall v. Hall, 10 Humph. (Tenn.) 352 (1849)..... 13

Hardaway v. National Surety Company, 211 U. S. 552, 53 L. Ed. 321 (1909) ..... 16, 40

Henningsen v. U. S. F. & G. Co., 208 U. S. 404, 52 L. Ed. 547 (1908) ..... 16, 20, 21, 23

Page

Hill v. American Surety Co., 200 U. S. 197, 203, 50 L. Ed. 437, 440 (1906) ..... 40
Holroyd v. Marshall, 10 H. L. Cas. 191, 211 (1862) ..... 10
Howell v. Comm. of Int. Rev., 69 F. (2d) 447, 450 (C. C. A. 8th, 1934); cert. den., 292 U. S. 654, 78 L. Ed. 1503 ..... 6
Illinois Surety Co. v. City of Galion, 211 Fed. 161, 163 (D. C. N. D. Ohio, 1913) ..... 20
Illinois Surety Co. v. Mitchell, 177 Ky. 367, 197 S. W. 844 (1917) .... 22
Ingersoll v. Coram, 211 U. S. 335, 53 L. Ed. 208 (1908) ..... 18
Jefferson v. Century Sav. Bank, 143 Iowa 83, 120 N. W. 308 (1909) .. 13
Jenkins v. National Surety Co., 227 U. S. 258, 72 L. Ed. 874 (1928), 10, 12, 13

Johnson Service Co. v. Monin, 253 N. Y. 417, 171 N. E. 682 (1930), 20, 21, 23

Kane, Trustee, v. First National Bank, 56 F. (2d) 534 (C. C. A. 5th, 1932) ..... 47
In re Kimbrough-Veasey Co., 292 Fed. 757 (D. C. N. D. Ga., 1923) .. 12
Kellas v. Slack, 129 Md. 535, 99 Atl. 677 (1916) ..... 40
Justice v. Empire State Surety Co., 209 Fed. 105 (D. C. E. D. Pa., 1913) ..... 29
Labbe v. Bernard, 196 Mass. 551, 52 N. E. 688 (1907) ..... 14
Lacy v. Maryland Cas. Co., 32 F. (2d) 48 (C. C. A. 4th, 1929) ..... 8, 23, 24
In re McGarry & Son, 240 Fed. 400 (C. C. A. 7th, 1917) ..... 19
McKallip v. Altoona, 265 Pa. 192, 108 Atl. 408 (1919) ..... 16
Maryland Cas. Co. v. Board of Water Commissioners, 66 F. (2d) 730 Minn., 1927) ..... 9, 49
Maryland Cas. Co. v. Fouts, 11 F. (2d) 71 (C. C. A. 4th, 1926) ..... 9
Millette Farmers El. Co. v. H. Poehler Co., 18 F. (2d) 430 (D. C. D. Minn. 1927) ..... 9, 49
National Surety Co. v. County Board, 15 F. (2d) 903 (C. C. A. 4th, 1926) ..... 24
New Amsterdam Cas. Co. v. City of Astoria, 256 Fed. 560 (D. C. D. Ore., 1919) ..... 8, 46
Olsness v. Baird, 52 N. D. 1, 201 N. W. 993 (1924) ..... 25
O'Neill v. Title Guaranty & Trust Co., 191 Fed. 570 (C. C. A. 6th, 1911) ..... 29
Prairie State Natl. Bank v. U. S., 164 U. S. 227, 41 L. Ed. 412 (1896). 14, 24
Pratt Lumber Co. v. T. H. Gill Co., 278 Fed. 783, 798 (D. C. N. C., 1922) ..... 16
Prince v. Neal-Millard Co., 124 Ga. 884 (1905) ..... 32
Reid v. Pauly, 121 Fed. 632 (C. C. A. 9th, 1903) ..... 19
Robinson v. Blaylock, 192 N. C. 407, 135 S. E. 136 (1926) ..... 8, 40
St. Peters Catholic Church v. Vannote, 66 N. J. Eq. 78, 56 Atl. 1037 (1904) ..... 23
In re Scofield, 215 Fed. 45 (C. C. A. 2d, 1914) ..... 44
Sexauer & Lemke v. Burke & Sons Co., 228 N. Y. 341, 127 N. E. 329 (1920) ..... 40
Somers v. U. S. F. & G. Co., 191 Calif. 542, 547, 217 Pac. 746 (1923) .. 6

Page

South Fork Canal Co. v. Gordon, 6 Wall. 561, 571, 18 L. Ed. 894 (1868) ..... 32
Southern Surety Co. v. Merchant & Farmers Bk., 203 Ind. 173, 195, 176 N. E. 846 (1931) ..... 40, 49
Springfield Natl. Bk. v. American Surety Co., 7 F. (2d) 44 (C. C. A. 8th, 1925) ..... 9
State ex rel. Southern Surety Co. v. Schlesinger, 114 Oh. Stat. 323, 151 N. E. 177 (1925) ..... 23
In re Stout, 100 Fed. 794 (D. C. W. D. Mo., 1900) ..... 9
Tennant v. U. S. F. & G. Co., 17 F. (2d) 38 (C. C. A. 3d, 1927) ..... 8
Tuttle v. School District, 62 Iowa 422, 17 N. W. 603 (1883) ..... 23
Union Stone Co. v. Hudson County, 71 N. J. Eq. 657, 65 Atl. 466 (1906) ..... 23
United States v. National Surety Co., 254 U. S. 73, 65 L. Ed. 143 (1920) ..... 25
U. S. F. & G. Co. v. Centropolis Bk., 17 F. (2d) 918 (C. C. A., 8th, 1927) ..... 14, 49
U. S. F. & G. Co. v. U. S., 191 U. S. 416, 48 L. Ed. 242 (1903) ..... 40
Van Stone v. Stillwell & Bierce Mfg. Co., 142 U. S. 128, 35 L. Ed. 961 (1891) ..... 32
Vermule v. York Cliffs Imp. Co., 105 Me. 350, 74 Atl. 800 (1909) .. 13
Walker v. Brown, 165 U. S. 654, 41 L. Ed. 865 (1897) ..... 18
Wasco County v. New England E. Ins. Co., 88 Oreg. 465, 172 Pac. 126 (1918) ..... 19, 46
Withrow Lumber Co. v. Glasgow Investment Co., 101 Fed. 863 (C. C. A., 4th, 1900) ..... 33
Wothausen v. Trimpert, 93 Conn. 260, 265, 105 Atl. 689 (1919) ..... 7

TREATISES AND ARTICLES.

Blair, The Allocation of After-Acquired Mortgaged Property Among Rival Claimants, 40 Harv. Law Rev. 222 (1926) ..... 10
Brandt, The Law of Suretyship and Guaranty, Vol. 1, Sec. 5 (3d ed., 1905) ..... 7
Dillon, Municipal Corporation, Vol. 2, Sec. 830 (5th ed., 1911) ..... 32
Jones on Liens, Vol. 1, Sec. 513 (3d ed., 1914) ..... 32
Pomeroy, Equity Jurisprudence, Vol. 3, Secs. 1235, 1238 (3d ed., 1905) ..... 18
Sheldon, The Laws of Subrogation, Sec. 102, p. 115 (1882) ..... 14
Stearns, The Law of Suretyship, p. 508 (4th ed., 1934) ..... 13

STATUTES.

United States Revised Statutes, Sec. 3468; Comp. Stat., Sec. 6374; Sec. 193 of Title 31 of U. S. C. A. ..... 23
Materialmen's Act of 1894, Chap. 280, 28 Stat. 278 and Amendments, 40 U. S. C. A., Sec. 270 ..... 33
Materialmen's Act of 1935, Public No. 321, 74th Congress, H. R. 8519, App. August 24, 1935 ..... 39

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## PETITIONER'S BRIEF FOR USE UPON ARGUMENT OF CASE.

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### Opinion of the Court Below.

The majority opinion of the Circuit Court of Appeals is reported at page 377 of 75 Fed. (2d), and the dissenting opinion of Circuit Judge Sibley at page 380 of the same volume. These opinions appear in the Record at pages 80 and 85.

### Jurisdiction.

The judgment to be reviewed is a judgment of the United States Circuit Court of Appeals for the Fifth Circuit, dated February 13, 1935 (R. 89). Being a judgment in a civil

case in a Circuit Court of Appeals, it is one which under Section 347 of Title 28 of the United States Code may be reviewed by this Court by certiorari upon the petition of any party thereto. Certiorari was granted by this Court on April 29, 1935.

## The Statute Involved.

The statute involved will be found in the Appendix *infra*, pp. 50, 51.

## Statement of Facts.

This case comes before this Court on writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit to review a judgment affirming a judgment of the District Court of the United States for the Northern District of Florida in favor of certain materialmen, respondents herein.

On November 8, 1930, M. J. Gray, trading as the Gray Artesian Well Company, entered into a contract with the United States Government for drilling a well at the Naval Air Station at Pensacola, Florida. The contractor gave a bond executed by the petitioner, the American Surety Company of New York, as surety, to the United States Government.

At the time that the contractor made application to the Surety for the bond in question, he gave to the Surety a written contract of indemnity, by Paragraph 7 of which it was agreed that in case of default by the contractor all moneys which might be payable on account of the contractor's contract with the Government should be credited upon any claim that might be made upon the Surety by reason of its undertaking (R. 45). The bond was given in the penal sum of $3940 and was conditioned upon the contractor's faithful performance of his contract to the Government and

upon prompt payment by the contractor to all persons furnishing labor and materials used in the prosecution of the project. The contract between the Government and the contractor authorized the Government to retain 10% of the total contract price until final completion and acceptance of the contract, provided, however, that after satisfactory completion of 50% of the work the remaining payments might be made in full (R. 17).

Gray completed the project but remained indebted in the sum of $5677.85 to the respondents who had furnished materials for use in the performance of the contract (R. 5). In a statutory proceeding in the District Court of the United States for the Northern District of Florida, the Surety paid into court the total penalty of its bond which was distributed ratably among the respondents. This sum, however, was not sufficient to pay them in full (R. 5).

At the time the contractor completed his contract the Government was indebted to Gray in the amount of $2724.23 as the balance due under the contract (R. 5), which amount the petitioner sought to recover in a proceeding in the Supreme Court of the District of Columbia (R. 58). One of the respondents, Runyon-Cobb Boiler Works, intervened in that proceeding, urging its superior equity in the fund. Gray had filed a petition in involuntary bankruptcy in the United States District Court for the Northern District of Florida. His trustee in bankruptcy also intervened in the District of Columbia proceeding. On the trustee's petition the District of Columbia court declined to pass upon the rights of the respective litigants to the fund and turned it over to the trustee in bankruptcy (R. 6). The petitioner duly filed its claim in the bankruptcy proceedings claiming an equitable lien and priority in the fund (R. 25, 54). The respondents asserted an equitable lien on the fund (R. 6), and filed objections to the allowance of the lien or priority claimed by the petitioner (R. 48, 60). The referee in bank-

ruptcy sustained their objections and allowed the respondents' claim of priority (R. 63).

The Surety then filed a petition with the United States District Court of the Northern District of Florida for a review of the referee's order (R. 64), and the District Judge affirmed that order (R. 66). The petitioner then appealed from the court's judgment to the United States Circuit Court of Appeals for the Fifth Circuit and that court by its judgment, dated February 13, 1935 (R. 89), sustained the order of the District Court. Whereupon the petitioner filed in this court its petition for writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit, which was granted on April 29, 1935 (R. 91).

## Questions Presented.

The issues raised by this case are:

1. Has the Surety a prior claim as against the suppliers of materials to the fund now in court?

2. Have the materialmen a priority in the fund which entitles them to receive that fund?

3. If the Surety is denied a preferred claim to the fund, can it prove its claim and share ratably with materialmen and other general creditors in the distribution of the fund?

## Specification of Errors.

1. The Circuit Court of Appeals erred in holding that, as against the respondents, petitioner is not entitled to priority of payment of its claim against the estate of the bankrupt contractor, out of the unpaid balance due the contractor remaining in the hands of the United States upon completion of the contract or to a lien upon said balance for its said claim.

2. The Circuit Court of Appeals erred in holding that, as against petitioner, respondents are entitled to priority of payment of their claims against the estate of the bankrupt contractor, out of the unpaid balance due the contractor remaining in the hands of the United States upon completion of the contract.

## Summary of Argument.

The question before this Honorable Court is one of competing equities in the reserved fund, as between the petitioner Surety and the respondent materialmen.

The Surety will first show the basis of its claim for preference to the fund. The Surety is entitled to the fund, first, because it has a direct right to the fund by reason of the law of indemnity; second, by virtue of principles of law analagous to those of subrogation; and, third, because a failure to pay this fund to the Surety would impair its rights under its original contract with the contractor and would bring about a failure of consideration. (Point I.)

The Surety will then show that the respondent materialmen have no priority to the fund now in court. The petitioner will argue that the materialmen have no equitable lien on the reserved fund as a result of any express contract or by reason of any applicable statute or by way of implication. It will be shown that the respondents are only general creditors of the contractor in so far as the rights of the Surety are concerned. (Point II.)

Finally, the petitioner will contend that even if it has no superior right to the fund, it should nevertheless, be allowed to share ratably with materialmen and other general creditors in the distribution of the fund. (Point III.)

## ARGUMENT.

### Point I.

### The Surety is Entitled to the Reserved Fund.

(A).

The Surety Has a Direct Right to the Fund.

It is elementary that a surety which has paid out money by reason of its undertaking has certain well recognized remedies by which it may seek to satisfy or mitigate its losses. Subrogation, indemnity and reimbursement are the usual remedies. These rights are independent of each other and are characterized by their own peculiar attributes. However, all of these remedies are predicated upon certain fundamental principles which underlie all of the various means by which it is sought to save a surety harmless from legitimate risks. The surety's rights are either direct or derivative.

(1) *By the law of indemnity the Surety has a direct right to the reserved fund.*

The decisions are clear that a contract of indemnity creates certain direct rights against the principal or against the security given by such agreement. It is not a collateral undertaking—it is a positive and distinct right arising from an express agreement or from certain circumstances to which the courts attach an implied agreement of indemnification.

*Howell v. Commissioner of Internal Revenue*, 69 F. (2d) 447, 450 (C. C. A. 8th, 1934), cert den. 292 U. S. 654, 78 L. Ed. 1503.

*Somers* v. *U. S. F. & G. Co.*, 191 Calif. 542, 547; 217 Pac. 746 (1923)

*Wolthausen v. Trimpert*, 93 Conn. 260, 265; 105 Atl. 687 (1919).

See:

*Brandt: The Law of Suretyship & Guaranty*—Vol. 1, Sec. 5 (2d ed. 1905).

In the instant case the principal and the surety have by specific agreement created a direct right to the fund in question. The contract of indemnity stipulates:

> "• • • and the Indemnitor further agrees in the event of any breach or default on his part in any of the provisions of any contract covered by the suretyship of the said Surety, • • • that deferred payments and any and all moneys and securities that may be due any payable at the time of such default, or on account of extra work or materials supplied in connection therewith, or that may thereafter become due and payable on account of said contract, shall be credited for any claim that may be made upon the said Surety by reason of its suretyship as aforesaid" (R. 34), 41.

The conclusion is inescapable that the true import of this contract was to create in the Surety a right to and an interest in "any and all money and securities that may be due and payable at the time of such default". It is, of course, imperative to the materialmen's claim to insist that a failure on the part of the contractor to pay their claims constitutes a default under the contract. If this be true, the very contingency which the contract of indemnity was designed to meet has taken place. It follows as a natural and proper consequence that the Surety has a direct right by reason of that agreement to all funds due and payable to the contractor. The contract is fairly susceptible of no other interpretation—that is its plain meaning. As such it is consistent with the intent of the parties and is violative of no principles of law. In view of these

unalterables, we respectfully suggest that no court should allow this agreement to be rendered an idle gesture or that its evident purposes be thwarted.

Judicial sanction for these principles is abundant. The authorities recognize such agreements as creating a direct right in the Surety which is cognizable and enforceable by the courts.

*Lacy* v. *Maryland Cas. Co.*, 32 Fed. (2nd) 48 (C. C. A. 4th, 1929).

*In re Dailey*, 19 Fed. (2d) 95 (D. C. N. J., 1926).

*Tennant* v. *United States F. & G. Co.*, 17 Fed. (2d) 38 (C. C. A. 3d, 1927).

*Globe Indemnity Co.* v. *Unity Railways Co.*, 272 Fed. 607 (C. C. A. 3rd, 1921).

*New Amsterdam Cas. Co.* v. *City of Astoria*, 256 Fed. 560 (D. C. Ore., 1919).

*Robinson* v. *Blaylock*, 192 N. C. 407, 135 S. E. 136 (1926).

While some of these cases do not involve any question of competing equities between a surety and materialmen, they, nevertheless, indutiably show the interest of a surety in a reserved fund. All are direct authority for the proposition that a surety has by reason of its contract of indemnity a direct right in the reserved fund which will be zealously protected by the courts.

(2) *The Surety has an implied right of indemnity, even though there be no express contract creating such a right.*

It was decided as early as 1633 that the principal was bound by implication to reimburse the surety—a counter-bond of indemnity was implied from the relationship of the parties.

*Ford v. Strowbridge*, Nelson Ch. 24 (1633).

Since that date the courts have decided times without number that upon the execution of a contract of suretyship there arises in the absence of an express agreement to the contrary an implied contract that the principal will indemnify the surety for any payment made in compliance with the suretyship undertaking.

*Millette Farmers El. Co.* v. *H. Poehler Co.*, 18 Fed. (2d) 430 (D. C. Minn., 1927).

*Springfield Natl. Bk.* v. *American Surety Co.*, 7 Fed. (2d) 44 (C. C. A. 6th, 1925).

*In re Stout*, 109 Fed. 794 (D. C. W. D. Mo., 1900).

(3) *An express contract of indemnity does not detract from the Surety's implied right of indemnity.*

There are decisions to the effect that an express contract of indemnity gives the surety no greater right than the implied obligation of the principal to indemnify, which the surety always has in the absence of an agreement to the contrary. Such cases purport to hold an express agreement in substance is surplusage.

*Maryland Casualty Co.* v. *Fouts*, 11 Fed. (2d) 71 (C. C. A. 4th, 1926).

*Springfield* v. *American Surety Co., supra.*

But whether they be sound or not, this much is clear—an express agreement of indemnity does not detract from any of the Surety's implied rights of indemnity. Such a contract is not a boomerang for the Surety—it does not serve to diminish rights that the Surety would otherwise have.

It thus appears that irrespective of whether it be determined that the Surety has a right of indemnity as a result of its express contract or because such a right is implied, the Surety has a direct right in the reserved fund by either of the above approaches.

(4) *The Surety has a greater right to the reserved fund under principles of indemnity than it has by the law of subrogation.*

It was urged by respondents below that the indemnity agreement gives the Surety no greater right than it would have on principles of the law of subrogation. As authority for this contention respondents rely upon the decision of this court in *Jenkins* v. *National Surety Co.* (277 U. S. 258, 72 L. Ed. 874, 1928). A careful analysis of that decision reveals that it is not applicable in the present case. In that case the Surety sought to share with other creditors in the distribution of the insolvent principal's estate on the basis of its indemnity agreement. The court denied the Surety's claim, until it was shown that the beneficiaries under the bond had been paid in full. The contract of indemnity in the Jenkins case, however, was very general in character. It was only a promise to indemnify the Surety for its losses out of the general assets of the principal's estate. No particular fund or asset of the principal was segregated or charged with a liability to reimburse the Surety. There was no definite appropriation of specific property to meet a potential liability. No trust fund was set up to meet any possible losses. In the case at bar the principal definitely set aside this fund as security for repayment of the Surety's losses. The present contract of indemnity is in the nature of a mortgage on after-acquired property.

*Barnes* v. *Alexander*, 232 U. S. 117, 121, 58 L. Ed. 530 (1914);

*Holroyd* v. *Marshall*, 10 H. L. Cas. 191, 211 (1862);

*Blair: The Allocation of After-Acquired Mortgaged Property Among Rival Claimants*, 40 Harv. L. Rev. 222 (1926).

It may be said that the effect of the contract of indemnity in the Jenkins case likewise had the effect of charging all of

the principal's assets with payment of any loss that the Surety might incur as a result of the excution of the bond. We suggest, however, that a distinction may well be made between the legal effect given to an instrument which impairs the security from which creditors always have a right to satisfaction and that which is given to an agreement which in no way affects any present assets of the principal, and which does not threaten any property to which the creditors have a right to look for payment. Courts in analogous cases have refused to disturb such agreements. It is well settled that a creditor cannot object to assignments or contracts of the principal dealing with a potential inheritance that he may receive. By like reasoning it would seem that the materialmen or other creditors could not challenge a contract such as we have in the present case.

An even more significant distinction is the fact that in the Jenkins case allowance of the Surety to participate in the assets of the principal along with the creditors who were the beneficiaries on the bond would deprive those creditors of assets which were unquestionably a part of the principal's estate and to which they were entitled to look for payment. Those assets were the properties to which the creditors should first look for payment. They were the primary source. Whereas, in the instant case the reserved fund has never become a part of the principal's estate—it has never come into the principal's hands. This fund had been encumbered before it came into actual existence with a primary equity in the United States Government for faithful performance of the contractor's contract and a secondary equity in the Surety Company for reimbursement of all expenditures made by the Surety in accordance with its bond. All rights or interest which the principal had or might acquire in this fund were necessarily subject to these superior equities. At best, the only right that the contractor ever had in this fund was conditioned upon the discharge of the two prior obliga-

tions. His failure to discharge both of those obligations extinguished every vestige of right that the contractor might ever have had in the fund. It thus appears that our problem is not one of competition between the Surety and the assured in the general assets of the principal as was the case in *Jenkins* v. *National Surety Company, supra,* but rather a situation where the general creditors lay claim to a fund which had been specifically appropriated to the Surety long before their claims came into existence and which was never a part of the principal's assets. The Surety's and materialmen's claims to this fund are not predicated on the assumption that the fund is a part of the principal's estate—their claims are made independently and in disregard of the principal. The materialmen purport to claim the fund on the ground that they have an equitable lien on the property—the Surety lays claims to the fund since it has a direct right to the fund.

From what has been said it follows that the Surety's claim to a priority in the reserved fund is not at war with the fundamental principle that a surety cannot be subrogated against its creditor. This precept is implicit in the *ratio decidendi* of the Jenkins case. As has been pointed out, there is no competition between the Surety and the materialmen since the Surety claims a fund to which the materialmen have no claim. (See Point II, p. 31, *infra.*)

That a surety is not entitled to be *subrogated* to the rights of its creditor until payment in full has been made is elementary. The weight of authority does not countenance *pro tanto* subrogation. This principle has no place in the law of indemnity or reimbursement. A surety may enforce its right of *indemnity* even though it has not paid the beneficiaries in full. Complete satisfaction of the creditors is not a condition precedent.

*In re Kimbrough-Veasey Co.,* 292 Fed. 757 (D. C. N. D. Ga., 1923);

*Jefferson* v. *Century Sav. Bk.*, 143 Iowa 83, 120 N. W. 308 (1909);
*Vermeule* v. *York Cliffs Imp. Co.*, 105 Me. 350, 74 Atl. 800 (1909);
*Bullock* v. *Campbell*, 9 Gill (Md.) 182 (1850);
*Hall v. Hall*, 10 Humph. (Tenn.) 352 (1849);
*Stearns: The Law of Suretyship*, p. 508 (4th ed., 1934).

Judge Sibley adopts this view in his dissenting opinion. He says (R. 89):

> "• • • The surety may be disentitled to have any relief by equitable subrogation until the materialmen are paid in full under principles asserted in *Jenkins v. National Surety Co.*, 277 U. S. 253, and *LeFlore County v. First National Bank*, 66 Fed. (2d) 9. But that does not prevent an assertion of its direct right to the security of the retained percentages, nor hinder its sharing with the materialmen, all as common creditors, in the bankrupt's general estate. • • •"

(5) *The Surety's right of indemnity to the reserved fund attached at the time that the contract of indemnity was executed.*

It has been shown that by principles of the law of indemnity the Surety has a direct right to the reserved fund. The time at which that right arises, therefore, becomes pertinent. The law is clear that upon the execution of the contract of suretyship certain inchoate rights come into existence. These rights remain embryonic until some contemplated contingency materializes. It is at that time that these rights crystalize and become enforceable by the courts. These rights came into existence at the time that the suretyship obligation arose. Their efficacy dates from

their birth or inception, and not from the time of their maturity.

*Prairie State Nat'l Bank* v. *U. S.*, 164 U. S. 227, 41 L. Ed. 412 (1896);

*U. S. F. & G. Co.* v. *Centropolis Bk.*, 17 Fed. (2d) 918 (C. C. A. 8th, 1927);

*American Surety Co.* v. *National Bank*, 17 Fed. (2d) 942 (D. C. S. D. Ohio, 1925);

*Griffin* v. *Long*, 96 Ark. 268, 131 S. W. 672 (1910);

*Labbe* v. *Bernard*, 196 Mass. 551, 52 N. E. 688 (1907);

*Sheldon: The Law of Subrogation*, Sec. 102, p. 115 (1882).

In *American Surety Company* v. *National Bank, supra*, the court said at page 944:

> "The written application, signed by the bank, through its officers, accepted by the surety company, evidenced by the issuance of the surety bond thereon, constituted a contract of indemnity, limited to the terms of indemnity expressed therein. The relationship of debtor and creditor between the bank and surety company was created on the acceptance of the application by the surety company. Liability dated from that moment. The question of amount of that liability became a determinable factor only after default upon the bond by the bank and the payment of the surety liability by the surety company."

Some courts have termed this metamorphism as the "relation back" theory. They reason that since the Surety has certain inchoate rights from the date of entering into the suretyship undertaking that upon performance of its obligations all rights accruing thereby relate back to the time when the contract was made. Mr. Justice Sheldon, in *Labbe v. Bernard, supra*, expressed it in this way:

> "While it is true that the rights of the sureties to the remedies of the principal do not become complete

and are incapable of enforcement until they have discharged their principal's obligation, yet their right becomes an inchoate one as soon as they have entered into the relation of suretyship; and their equitable assignment of their principal's rights and remedies, when completed by the performance of his obligation relates back * * * to that earlier time."

Thus in the case at bar the Surety upon giving its bond received in return certain inchoate rights which became consummate at the time the contractor defaulted on its contract by failure to pay materialmen. It was then that the Surety's direct right to the reserved fund became complete, but that right related back to the time of its genesis, and takes effect as of that date. Any right or interest that the materialmen might have in the reserved fund is, therefore, necessarily subsequent and subject to the prior right of the Surety unless the materialmen are given some superior equity by statute. No applicable statute creates such a right. (Point II, p. 32, *infra.*)

The respondents have argued below that the principles of "relation back" are not applicable in this case. They assert in effect that although the "relation back" theory might apply in certain cases, it cannot be invoked in a case where its application would defeat "the collateral rights of third persons". The respondents' argument completely befogs the issue. Our problem is not whether intervening rights of third persons may be cut off by the "relation back" theory, but rather have the third persons any rights to be cut off by operation of the "relation back" doctrine. It will be shown that the respondents have no rights or interests in the reserved fund. (Point II, p. —, *infra.*) If the respondents have no right in or claim to the reserved fund, there is no justification for preventing the natural operation of the "relation back" theory. Nor can it be said that it affects a frustration of the ends of justice,

since the materialmen are possessed of no rights which may thus be damaged or jeopardized.

The argument of the respondents is circular and make-believe to the ultimate. First in some inexplicable manner they create a right in the materialmen to the fund. This they dignify as an equitable lien. A right having been created, they then recite that the "relation back" theory is not pertinent because it would defeat those *rights* of the materialmen. It is submitted that since the materialmen have no interest in the reserved fund, as will be shown (Point II, p. 16, *infra*), there is no force in the respondents' suggestion that the "relation back" theory is inapplicable.

However, the soundness of the respondents' general proposition may well be doubted when it is considered that the Surety was allowed to prevail by reason of the relation back theory over the intervening rights of the assignee banks in *Prairie State Bank v. United States*, *supra*, and in *Hemmingsen v. United States F. & G. Co.*, 208 U. S. 404; 52 L. Ed. 547, (1908). Their rights, if any, were wiped out by giving effect to the Surety's inchoate right of subrogation.

It should also be pointed out that in the final analysis it makes no essential difference whether it is said that the Surety has a direct right in the reserved fund by virtue of its contract of indemnity or as a result of governing principles of the law of reimbursement or of equitable assignment. For the purposes of this case it is largely a matter of nomenclature.

*American Surety Co.* v. *Finletter*, 274 Fed. 152, (C. C. A. 3rd 1921);

*Pratt Lumber Co.* v. *T. H. Gill Co.*, 278 Fed. 783, 798, (D. C. N. C. 1922);

See: *McKallip* v. *Altoona*, 265 Pa. 192, 108 Atl. 408 (1919).

The respondents argued that if the contract of indemnity be construed as an equitable assignment the Surety, as an assignee, would receive no greater rights than the assignees received as assignees in *Henningsen* v. *United States F. & G. Co., supra,* and in *Hardaway* v. *National Surety Company* (211 U. S. 552, 53 L. Ed. 321, 1909). This is unsound. The claims of the assignees in the Henningsen case and in the Hardaway case were denied because the surety had certain inchoate rights in the fund just as the Surety has in the present case. The Surety's rights were held to be superior to the rights of the assignees. In the present case if the Surety is an assignee, it is not competing with a creditor who has any inchoate rights or any direct rights to the fund, but rather with a claimant who has no right whatever to the fund. (Point II, p. 31, *infra*). The analogy attempted to be drawn by the respondents from the Henningsen and Hardaway cases must fail.

A study of the apposite cases reveals that although the courts have pursued somewhat diverse processes of reasoning in arriving at their ultimate conclusion in these cases, nevertheless, they are all in accord, with a few explainable exceptions, in their final result, which gives the surety a direct right to the reserved fund. Some courts have reached their decision by the vehicle of recognizing the express or implied contract of indemnity, others have used the *modus* of reimbursement, while others have relied upon the law of equitable assignment. The inarticulate major premise in all of these cases seems to be the recognition of the fundamental equity of the surety. Of course, it is true that in many of these cases there was no contest between a surety and materialmen, but that fact does not destroy their intrinsic value as a guide to the correct determination of the rights of a surety in similar situations. Those cases are all authorities for the proposition that the surety has a right

to a reserved fund. These decisions are based upon fixed principles of law and not upon the personality of the litigants in the particular case.

(6) *The Surety has an equitable lien on the reserved fund.*

Equitable liens may be created by express contract or they may be implied because equitable considerations demand such in order to prevent injustice.

*Pomeroy, Equity Jurisprudence,* Vol. 3, Secs. 1235, 1238 (3d ed. 1905).

Where there is a distinct appropriation of certain property with the intention that it shall secure the payment of a debt or obligation, an equitable lien is thereby placed on the property.

*Ingersoll* v. *Coram,* 211 U. S. 335; 53 L. Ed. 208 (1908); *Walker* v. *Brown,* 165 U. S. 654; 41 L. Ed. 865 (1897).

In *Walker* v. *Brown, supra,* the court cited with approval this language from Pomeroy's Treatise on Equity Jurisprudence (p. 664 of 165 U. S.):

> "The doctrine may be stated in its most general form that every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund, therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforceable against the property in the hands, not only of the original contractor but of his heirs, administrators, executors, voluntary assignees, and purchasers or encumbrancers with notice * * *."

The contract of indemnity plainly creates an equitable lien for the Surety on the reserved fund. The agreement satisfies all of the elements that are necessary to establish an equitable lien. By that agreement there is a segregation of certain property; there is a definite identification of that property; and there is a manifest intention on the part of the parties to have the fund become security for any loss that the Surety may suffer in the undertaking.

The decisions are legion which sustain the equitable right of the surety to a reserved fund that has been set aside by the provisions of the original contract between the governmental agency and the contractor.

*Prairie State Bank* v. *United States, supra*
*Globe Indemnity Co.* v. *Unity Railways, supra*
*Reid* v. *Pauly*, 121 Fed. 652, (C. C. A. 9th, 1903)
*Wasco County* v. *New England E, Ins. Co.*, 88 Oreg. 465; 172 Pac. 126 (1918)

Mr. Justice White, speaking for the court in *Prairie State Bank* v. *United States, supra*, at page 233 said:

> "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of the consideration, is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created; and that a disregard of such stipulation by the voluntary act of the creditor operates to release the sureties, is amply sustained by authority. • • •"

Since the Surety has a direct right as a consequence of its equitable lien on the fund in question, and since that direct right came into existence at the time that the suretyship contract was made, it is submitted that the Surety is entitled to receive the retained fund.

B.

EQUITABLE PRINCIPLES ANALOGOUS TO SUBROGATION DEMAND THAT THE SURETY SHOULD HAVE THE RESERVED FUND.

Even if it be assumed that the Surety has no direct right to the fund in court, still the petitioner would be entitled to the fund on principles which closely parallel those of subrogation. There is the highest authority to the effect that a surety in a position similar to that of the petitioner is "subrogated to the rights and remedies of the contractor".

*Hardaway* v. *National Surety Company, supra.*

*Henningsen* v. *U. S. F. & G. Co., supra.*

*Johnson Service Co.* v. *Monin,* 253 N. Y. 417; 171 N. E. 682 (1930).

*Illinois Surety Co.* v. *City of Galion,* 211 Fed. 161, 163. (D. C. N. D. Ohio, 1913).

*Wasco County* v. *New Eng. E. Ins. Co., supra.*

While it may be said that technically a surety can only be "subrogated" to the rights of creditors whom it pays, there are, nevertheless, certain rights which a surety may derive from the contractor as a consequence of legal precepts akin to those of subrogation. Judge (now Mr. Justice) Cardozo put it in this way in *Johnson Service* v. *Monin, supra:*

> "In thus holding the surety to the performance of its covenant, we do not leave it helpless, without means of reimbursement. What it pays to the municipality will be subject to a trust for the benefit of the Buckeye Blower Company (the materialman), and indeed for the avoidance of circuity may be paid to that company directly. In return it (the surety) will have the right to be subrogated in an equivalent amount to the right of its own principal, the general contractor, to collect from the municipality the balance due under the con-

tract. Henningsen v. United States Fidelity & Guaranty Co., 208 U. S. 404, 28 S. Ct. 389, 52 L. ed. 547; Lacy v. Maryland Casualty Co. (C. C. A.) 32 F. (2d) 48. In the end, the materialman will have reimbursement from the surety, and the surety from the city. The loss will fall on the contractor who in equity should bear it."

The decision of this court in *Henningsen* v. *United States F. & G. Co., supra*, also takes the same approach. In that case there was a contest between the surety and an assignee bank for the retained percentage. This court held that the fund belonged to the surety by virtue of its right of subrogation. The court, in speaking of subrogation, however, failed to state to whose rights the surety was subrogated. The respondents urge that the court meant that the surety was subrogated to the rights of the creditor materialmen. No foundation whatever for this inference is to be found in the court's opinion. On the other hand, the head-note of the official report states: "In such a case the surety is subrogated to the rights of the contractor, but the bank is not." (208 U. S. 404).

We suggest that the term "subrogation" is there used in the same sense as it was used by Mr. Justice Cardozo, (and that is the sense in which it is hereafter used in this subdivision of the brief), when he spoke of the right of the surety "to be subrogated * * * to the right of its own principal, the general contractor, to collect from the municipality the balance due under the contract". (*Johnson Service Co.* v. *Monin, supra*). It therefore appears that even if the direct right which the surety has in or to the reserved fund be denied, the Surety, nevertheless, has a right to be "subrogated" to the rights of the contractor to collect the unpaid balance from the United States Government.

The respondents urge, however, that even if the Surety is "subrogated" to the rights of the contractor, it would

have no preferred right to the fund as against the claims of materialmen. The respondents admit that the Government may pay the money over to the contractor and that the contractor can spend the money as he sees fit. (Respondents' Brief, Circuit Court of Appeals, p. 19). If the Surety may be "subrogated" to this right of the contractor, it would seem that the contractor has a superior claim to the fund. It has been repeatedly held that a surety may be subrogated to the rights of the contractor even though there be general creditors of the contractor existent at that time.

*Hardaway* v. *National Surety Co., supra.*

*Illinois Surety Co.* v. *Mitchell,* 177 Ky. 367; 197 S. W. 844 (1917).

*First National Bank* v. *Pesha,* 99 Neb. 785; 157 N. W. 924 (1916).

*Hackensack Brick Co.* v. *Borough of Bogota,* 86 N. J. Eq. 143; 97 Atl. 725 (1916).

*Johnson Service Co.* v. *Monin, supra.*

*Crown Lumber Co., Ltd.* v. *Smythe,* [1923] 3 D. L. R. 33.

It is asserted, however, that the materialmen are entitled to different treatment from that accorded the contractor's general creditors; that there is some transcendent equity existing in their favor. It is difficult to discover just why materialmen's rights are so sacrosanct as compared to the rights of other general creditors.

No question as to the relative equities of the materialmen on the one hand and the contractor on the other to the fund arises in a determination of the surety's right to be "subrogated" to the contractor's claim to the fund. The equities should be balanced as between the surety and the materialmen, and not as between the contractor and materialmen. It will be pointed out (Point II, p. 44, *infra*) *that* the equities of the situation distinctly preponderate in the Surety's favor.

The petitioner submits that if this court follows the reasoning of the *Henningsen* case and of *Johnson Service Co. v. Monin, supra,* the fund in court will be turned over to the Surety. The principles announced in those cases inevitably lead to that end.

Another line of cases which is very analagous to the instant situation and which strongly suggests its correct disposition is that group of cases which holds that where the surety completes the contract of the defaulting contractor, the surety is subrogated to the rights of the governmental agency.

*Prairie State Bank* v. *United States, supra*
*Maryland Casualty Co.* v. *Board of Water Commissioners,* 66 Fed. (2d) 730 (C. C. A. 2d 1933)
*Lacy* v. *Maryland Cas. Co., supra*
*First National Bank* v. *City Trust, etc. Co.,* 114 Fed. 529 (C. C. A. 9th 1902)
*State ex rel Southern Surety Co. v. Schlesinger,* 114 Oh. Stat. 323, 151 N. E. 177 (1925)
*United States Revised Statutes,* Sec. 3468, Comp. Stat. Sec. 6374, Sec. 193 of Title 31, U. S. C. A.

The fact that there are unpaid laborers and materialmen does not destroy the surety's right to be subrogated to the rights of the state where the surety has completed the contract.

*Union Stone Co.* v. *Hudson County,* 71 N. J. Eq. 657, 65 Atl. 466 (1906)
*St. Peter's Catholic Church* v. *Vannote,* 66 N. J. Eq. 78, 56 Atl. 1037 (1904)
*Tuttle* v. *School District,* 62 Ia. 422, 17 N. W. 603 (1883)

These cases all hold that where the surety has completed the contract of its principal that the surety thereby receives

by way of subrogation whatever rights the state had in the premises. That is the settled law of the Federal courts.

*Prairie State Bank* v. *United States, supra*
*Maryland Cas. C.* v. *Bd. of Water Comm., supra*
*Lacy* v. *Maryland Cas. Co., supra.*
*National Surety Co.* v. *County Board,* 15 Fed. (2d) 993 (C. C. A. 4th, 1926)

As a matter of substantive law it is difficult to see why it is that the surety should be given a right of subrogation to the state's rights where it actually completes the contract and should not have that right where the surety provides for the completion of the contract. Is there any substantial or real ground for allowing the surety relief where it does the work directly and denying the surety this right where it pays for the work that has been done, or where it has served as the impetus for the work that was done? Regardless of whether the surety does the work or whether it pays for it, the final result is essentially the same—the surety is out of pocket in both cases, the governmental unit receives the benefit of the surety's work or bond in either case, and if the surety receives the retained fund, there may be unpaid materialmen in either situation. To pose the issue concretely, if the Contractor had defaulted in the present case and if the Surety Company had expended $3940 for labor and materials, there would be no doubt that the Surety would be entitled to the reserved fund. What material difference in law can it make that the Surety has paid out $3940 to materialmen for work that they have already done instead of making actual purchases and payments for materials? An attempt to make a differentiation between the surety which takes over the contract and actually completes the project and the surety which furnishes the money which is used to pay those who furnished materials yesterday seems highly arbitrary.

It may be urged that the present Surety has not relieved the Government from any obligation or that it has done nothing for the Government which entitles it to be "subrogated" to the rights of the Government. True, in the strict sense of the word, the Surety has not done anything that would give it any rights under conventional subrogation, but it is submitted that certain principles of equity which are closely related to those applicable in the law of subrogation and which have been applied by the courts in numerous cases decree that sureties circumstanced similarly to the present petitioner recover the reserved fund.

Further it is not accurate to say that the present Surety has done nothing for the Government. The Government has benefited from the bond in a number of ways. The Government has received everything that it contracted for under the bond—this was made possible in no small degree because the Surety's undertaking was the prime assurance to the Government that the contract would be completed.

It almost goes without saying that the accrual of such a benefit to the Government should constitute sufficient ground for granting the surety a remedy that is very similar to that of subrogation. A decision to that effect would be in conformity with the holding of this court in the Prairie State Bank case.

Doubtless the respondents will recognize the merit of this assertion and attempt to fall back on the general rule of law that a surety cannot be subrogated against his creditor. That is undoubtedly the weight of authority in this country. There is, however, respectable authority to the contrary.

*In re American Products Co.*, 224 Fed. 401, (Appeal dismissed 239 U. S. 637; 50 L. Ed. 480).

Contra: *United States* v. *National Surety Co.*, 254, U. S. 73; 65 L. Ed. 143 (1920).

*Olsness* v. *Baird*, 52 N. D. 1, 201 N. W. 993 (1924).

The petitioner will not undertake to deny or debate this question since it is not considered to be applicable or controlling in the case at bar. Mr. Justice Brandeis (at page 76) has stated the rule to be as follows:

> "• • • This result is in harmony with a familiar rule of the law of subrogation under which a surety liable only for part of the debt does not become subrogated to collateral or to remedies available to the creditor unless he pays the whole debt, or it is otherwise satisfied." (*U. S.* v. *National Surety Co., supra.*)

In the present case the Surety is not asking that it be subrogated "to collateral or remedies available to the creditor." The Surety makes no claim to the fund through the materialmen—no effort is made to be subrogated to any possible rights of the materialmen. Indeed, it is the Surety's position that the materialmen have no claim to the fund (Point II, p. 31, *infra*). The Surety contends that it is "subrogated" to the rights of the contractor or of the Government, or both.

The Surety therefore is not demanding that it be "subrogated" to the rights of a creditor who has not been paid in full, but rather says that it is "subrogated" to the rights of the contractor or the Government.

The argument was also advanced below that the Surety had not fulfilled its obligations under the bond. It is said that since the bond provides that payment be made "to all persons supplying the principal with labor and materials" (R. 20), that payment of the full penalty of the bond does not extinguish the suretyship obligation. Just what type of duty or obligation the Surety has to materialmen after it has paid the full amount of the bond is not disclosed. The respondents attempt to make the bond a blanket undertaking, but at the same time they are forced to admit that it has certain limitations. It is indeed a strange obli-

gation that cannot be extinguished even by payment in full. Just how far this super-imposed duty goes is not divulged.

It is interesting to note, however, that the bond only stipulates that payment be made "to all persons." It does not state that the contractor shall make payment "to all persons" *in full*. When this fact is considered along with the complete lack of any promise whatever on the part of the contractor in either the contract or bond to pay materialmen in any amount and that even though a larger bond could have been demanded, it was, nevertheless, expressly limited to $3940 by the contracting parties, it may well be doubted that it was ever the intent of the parties that such broad language should be read into the bond.

In support of their position the respondents relied on the case of *Maryland Casualty Co.* v. *Fouts, supra.* In that case, however, the bond was expressly conditioned that "all moneys" belonging to the obligee should be repaid in full. These suggestions may appear to be somewhat technical, but we submit that they are sound. It is only by the most technical and labored reasoning that respondents argued that the present Surety's obligation was not terminated when it paid the full penalty of the bond.

The court had presented to it a situation in *In re American Products Co., supra,* which is almost identical to the one involved in the instant proceeding. In that case there was a contest between the surety and the unpaid materialmen for the retained percentage. The surety had paid the full amount of its bond, and this money was distributed ratably among the creditors—each receiving about 50% of his claim. The contractor had been adjudged bankrupt. The court held that the surety was entitled to prove the amount of such payments against the bankrupt's estate. It is true that this bond was given in compliance with certain municipal ordinances, but it does not appear that they were in any

essential way different from the Federal Statute. The court said (p. 403):

> "And it is also true that at the date of the bankruptcy the Surety Company had paid all it was bound to pay, and had become in equity the creditor of the Product Company to the full amount of the bond. It had never undertaken to pay all the debts of the Product Company; its promise was to pay them up to the limit of the penal sum, and, having discharged that obligation it was bound no further to those creditors, either legally or equitably. In our opinion, the argument in support of the decree goes astray just at this point. The position of counsel is based on the evident assumption that the Surety Company is still under some obligation to these creditors, and therefore cannot be allowed to share in the fund until the creditors themselves have been paid in full. But we do not so understand the facts. In substance the situation is this: The Surety Company agreed to pay as much of these debts as could be discharged with $34,395, and it met this obligation faithfully. * * *"

We submit, however, that it is immaterial as to whether the petitioner has fully discharged its obligation to the materialmen. As heretofore stated, petitioner makes no claim to the rights, if any, of the materialmen, but urges that by reason of certain legal principles, which are closely akin to subrogation, it is "subrogated" either to the rights of the contractor or the Government. The surety has fulfilled all of its covenants to both of these parties and is, therefore, entitled to be "subrogated" to their rights.

But, even if the Surety has no right of subrogation, the absence of such right in no manner affects its direct right to the fund by virtue of the relationship of the parties and as an incident of its contract of indemnity as has been shown previously (Point .I, p. 6, *supra*). Nor is that right conditioned upon the Surety's full discharge of all obligations under its bond.

(C).

PAYMENT OF THE RETAINED FUND TO THE MATERIALMEN WOULD CONSTITUTE AN IMPAIRMENT OF THE SURETY'S RIGHTS UNDER THE ORIGINAL CONTRACT.

Thus far the petitioner has shown that it has a right to the reserved fund which is superior to that of the materialmen. This reserved fund was set aside by the terms of the original contract between the Surety and the contractor as a trust fund or security out of which the Surety was to be reimbursed for all deficiencies under the contract. The fund was definitely marked for that purpose. The respondents now seek to divert the fund from that channel—this Court is now asked to apply the ear-marked property in such a way as utterly to defeat all interest that the Surety has in the fund. This ought not to be done. The rights of the petitioner in the security may not be impaired.

*Prairie State Bank* v. *United States*, *supra*.

*Justice* v. *Empire State Surety Co.*, 209 Fed. 105 (D. C. E. D. Pa. 1913).

*O'Neill* v. *Title Guaranty & Trust Co.*, 191 Fed. 570 (C. C. A. 6th, 1911).

All of these cases support the proposition that a surety's interest in the security given for its protection must be respected. An impairment of such security releases the surety from its undertaking. Mr. Justice White gave very careful consideration to this question in the Prairie case. Attempts have been made to make it appear that the Prairie case was decided solely on the ground that since the surety completed the defaulting contractor's contract that it was subrogated to the rights of the Government and was entitled to the fund. It is, therefore, said that the Prairie case is inapplicable in our immediate situation. There might be some weight in the respondents' suggestion if the last half of Mr. Justice

White's opinion could be disregarded. In that portion of the opinion it is clearly shown that the court did not decide the case wholly on the theory of subrogation, but also decided that since the surety had an equity in the reserve fund, any diversion of that fund would impair its rights and relieve the surety. The court refused to allow the fund to be diverted from the surety. It is equally significant that the court did not consider this right of the surety in the fund to arise because the surety had completed the contractor's contract. The court held that this right was created by the original contract just as it was in the case at bar. The court said (164 U. S. pp. 239, 240):

> "Applying the principles which are so clearly settled by the foregoing authorities to the case at bar, it is manifest that if the transaction in February, 1890, by which the Prairie Bank acquired its alleged lien on the fund possessed the effect contended for by the bank, it would necessarily operate to alter and impair rights acquired by the surety *under the original contract.*" (Italics ours.)

Nor should it be overlooked that the contract of indemnity was offered and submitted to the Surety by the contractor along with its original application for the bond. This contract was a part of the original contract. The agreement was a substantial part of the consideration which induced the Surety to execute the bond; it tended to lessen the risk and consequently decreased the amount of the premium charged for the bond. All of these factors entered into the original negotiations and were undoubtedly powerful influences in bringing about the execution of the bond. If the Surety is now to be stripped of the benefit which this contract conferred upon it, there will be a failure of a substantial part of the consideration given for the bond. This result should be avoided.

The petitioner submits that it is entitled to the reserved fund since it has a direct right to the fund, since it has a right to be "subrogated" to the rights of either the contractor or the United States Government, and since a failure to apply this fund to the ends designated by the contract between the Surety and the contractor would bring about an impairment of the petitioner's rights and since it would result in a failure of consideration.

## Point II.

## The Materialmen Have Only a General Creditor's Claim to the Reserved Fund.

### (A).

### The Materialmen Have no Equitable Lien on the Fund.

Some general observations have already been made concerning the nature and attributes of equitable liens (Point I, p. 18, *supra*). Equitable liens may be created by express contract or they may be implied where equity and good conscience justify their creation. However, the courts do not recognize every moral or equitable obligation as warranting the implication of an equitable lien. There are settled rules of law which guide the courts in dealing with this somewhat intangible and nebulous right—the courts do not use this power as a "roving commission" to reform and protect *sui juris* individuals against their own errors and shortcomings. Thus in our present case it is incumbent upon the materialmen to advance some justification based upon concrete principles of law or fact and not upon empty generalities which will sustain the imposition of an equitable lien upon the fund now in court. The materialmen must show that their alleged equitable lien is created either by some statute or by an express contract, or that in compliance with established principles of law an equitable lien exists.

1. *No express contract gives materialmen an equitable lien on the fund in question.*

Admittedly, the materialmen have no equitable lien by reason of any express contract. There is no agreement that would give the slightest color or comfort to the respondents in this respect. Indeed, the majority opinion of the Court of Appeals concedes that without the aid of a statute, laborers and materialmen are simply general creditors of a contractor. Judge Walker, speaking for the majority in the Court of Appeals, said (R. 82):

> "• • • In the absence of a statute on the subject, furnishers of labor or material to a contractor have the legal status of general creditors. • • •"

2. *The materialmen have no equitable lien by reason of any statute or statutes.*

The common law afforded materialmen no special relief against the property improved or against the reserved fund, unless there be some special contract provision creating such a right. While the Roman law was otherwise, the English law did not recognize or enforce such rights. The American decisions are in accord with the English common law.

*Van Stone* v. *Stillwell & Bierce Mfg. Co.*, 142 U. S. 128, 35 L. Ed. 961 (1891).

*South Fork Canal Co.* v. *Gordon*, 6 Wall 561, 571, 18 Law Ed. 894 (186[redacted]

*In re Fowble*, 213 ed[redacted]6 (D. C. Md., 1914).

*Prince* v. *Neal-Millard Co.*, 124 Ga. 884; 53 S. E. 761.

See *Dillon, Municipal Corporations*, Vol. 2, Sec. 830 (5th Ed., 1911).

*Jones on Liens*, Vol. 1, Sec. 53 (3rd Ed., 1914).

Nor does the insolvency of the debtor contractor change the status of the materialmen.

*Withrow Lumber Co.* v. *Glasgow Investment Co.*, 101 Fed. 863 (C. C. A. 4th, 1900).

Does any controlling statute or statutes give the present materialmen an equitable lien on the funds which are now in court? The majority of the Court of Appeals accepted the argument made by the respondents that the Act of August 13, 1894, and its amendments, (Chap. 280, 28 Stat. 278; Feb. 24, 1905, Chap. 778, 33 Stat. 811; Mar. 3, 1911, Chap. 231, Sec. 291, 36 Stat. 1167; 40 U. S. C. A., Sec. 270), gave materialmen a lien on the reserved fund in addition to the rights which they have by the statutory bond. There is nothing in the terms of the statute itself which justifies this inference. Notwithstanding, the court in some way found that although materialmen did not possess this right before the statute was enacted, the materialmen did have such a right after its enactment. The reasoning by which the court arrives at this conclusion is, we submit, unsatisfactory and unsound. The court said (p. 82):

> "• • • In the absence of a statute on the subject furnishers of labor or material to a contractor have the legal status of general creditors. Before the enactment of any Federal statute on the subject, it was not unusual for the Government to recognize the existence of a moral duty to protect furnishers of labor or material for a public work against dishonest or reckless contractors by requiring the insertion in a contract for such work of a provision requiring payment by the contractor of amounts owing by him to furnishers of labor or material for the work contracted for, or entitling the Government to withhold payments to the contractor if he failed to pay promptly those who furnished labor and materials. Greenville Sav. Bank *v.* Lawrence, 76 Fed. 545. It appears from decisions referred to below

> that the Government's observance of that duty in practical and effective ways was the precursor of judicial recognition of an enforceable equitable right of unpaid furnishers of labor or materials for that work in or to a part of the contract price thereof remaining in the possession of the Government after the completion of that work by the contractor. Nothing contained in the statute in pursuance of which the bond on which appellant was surety was executed is inconsistent with the Government's recognition of the continued existence of a duty to protect furnishers of labor or material, with the result of making such furnishers beneficiaries of the funds withheld by the Government. • • •"

The court first states that laborers and materialmen have no lien in the absence of a statute creating such a right. The court then speaks of a moral obligation on the part of the Government to see that materialmen are paid and that this obligation was recognized before the enactment of a Federal statute *when the contract provided that such be done.* The recognition of that duty by the Government, the court says, was the "precursor of judicial recognition of an enforceable equitable right" in unpaid materialmen to the funds withheld by the Government. It is then said that "nothing contained in the statute in pursuance of which the bond • • • was executed is inconsistent with the Government's recognition of the continued existence of a duty to protect furnishers of labor and materials, with the result of making such furnishers beneficiaries of the funds withheld by the Government". But where has the Court shown that the statute created the equitable lien? Indeed, it would seem that the statement of the court that "in the absence of a statute" materialmen have no preferred status and the court's statement that nothing in the statute is "inconsistent with the Government's recognition of the continued existence of a duty" to protect materialmen are contradictory. We respectfully submit that the majority opin-

ion in no way explains or shows how or in what way the Act of August 13, 1894, as amended, establishes an equitable lien on the retained percentage.

The majority opinion goes on to say that the case of *Henningsen* v. *United States F. & G. Co., supra,* supports their conclusion that after the Act of 1894 materialmen have an equitable lien on funds held back. This assumption is based upon the following language from the Henningsen case:

> "• • • It (the surety) paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that laborers and supply men were paid. • • •"

There is nothing in this statement which indicates that the so-called "equitable obligation" on the part of the Government to see that materialmen are paid created an equitable lien on retained funds. The words "equitable lien" are not to be found in the court's opinion. There is not the slightest intimation in the decision that materialmen have such a right. The petitioner urges that whatever "equitable obligation" the Government has is incorporated in the surety bond. When a bond is given in accordance with the statute and its penalty is fixed at such amount as the Government believes adequate to protect the materialmen, and that sum is paid in full by the surety, the Government has discharged whatever "equitable obligation" it ever had to see that materialmen are paid. This suggestion is entirely consistent with both the language and result of the Henningsen case. If the Government has some greater obligation than this, why was not provision made for it in the Act of 1894 or in the subsequent amendments thereto? The terms of the statute are themselves silent refutations of the respondent's position.

If the Government has an equitable obligation that transcends even the bond, it is timely to inquire as to the limitations of this obligation. We may well speculate as to where this argument will lead. What would be the Government's obligation if both the bond and reserved fund failed to pay materialmen in full? If the respondents are correct, the Government still has not extinguished its equitable obligation to the materialmen. Will the materialmen then have a claim against the Government? The law is settled beyond doubt that the Government may ignore the claims of materialmen with impunity even though the contract authorizes the Government to make payment of the reserved fund to the materialmen. The courts deny materialmen any relief against the Government in such a situation.

*Dupont, etc. Co.* v. *City of Glenwood Springs*, 19 Fed. (2d) 225 (C. C. A. 8th 1927).

*In re Fowble, supra*

*Columbia Brick Co.* v. *District of Columbia*, 1 App. D. C. 351 (1893).

Much emphasis was also placed in the majority opinion of the Court of Appeals and by the respondents upon the interpretation given the Henningsen case by the court in *Belknap Hardware Co.* v. *Ohio River Contract Co.* (271 Fed. 144; C. C. A. 6th 1921). In that case the contest was between the unpaid materialmen and the contractor's general creditors. The Belknap case only decides that as between materialmen and general creditors of the contractor the materialmen have a superior right to the retained funds. The court expressly limited its opinion to that issue. Judge Denison said (p. 149):

> "If this is the true principle of the decision, it may not be clear what the rights of the parties would be in the various situations that might arise, e. g., as between a surety who had performed the contract and claimants

> of this class unpaid when the surety took it over, *or as between a surety who had paid claims of this class to the limit of his bond and the unpaid remainder of the same class; but those questions can be met when they arise.* * * *" (Italics ours.)

It follows that what was said by the court in the Belknap case with respect to the Henningsen case is not controlling in the case at bar. However, if the Belknap case can be considered in the present case, it is clear that the force of that decision must depend upon whether the court correctly interpreted the holding of this court in the Henningsen case. Since it has been shown, we submit, that nothing in the Henningsen case creates an equitable lien for materialmen, necessarily the interpretation given the Henningsen case by the court in the Belknap case is unwarranted. Indeed, the court indicated in the Belknap case that, if it did not feel bound by the Henningsen case, as construed, its decision might have been otherwise.

Judge Denison also recognized that an equitable lien on behalf of materialmen must come from some statute or contract. He states (p. 147):

> "* * * It is commonly held that this lien or priority is wholly statutory and we are not aware of any case (unless those hereafter discussed) where, without the aid of any contract or statute, this vague equity of materialmen and laborers has been thought sufficient to put the owner of the property under obligation to see that they were paid before he settled with the contractor."

If it is the law that materialmen's equitable lien must be founded on some statute, in the absence of a contractual lien, it seems strange that no court has found any provision in the Act of 1894, or any other statute, which has that effect. No satisfactory explanation was adduced in the Bel-

knap case or in the majority opinion of the Court of Appeals in the instant case or in any other case cited below by the respondents. Judge Sibley aptly said that "I see no basis for one (equitable lien) without judicial legislation." (R. 85.)

The case of *Alfred Richards Brick Co.* v. *Rothwell*, 18 App. D. C. 516 (1901) is sometimes cited as holding that the Act of 1894 establishes an equitable lien on reserved funds? While there is some language in that case which supports such a supposition, none of it was necessary to a decision of the issues in the case and was pure *dicta*. There the contest for the reserved fund was between the general creditors of the contractor and its surety. The rights of materialmen were not involved.

An examination of the Congressional debates and its committees' hearings and reports fails to reveal any intent on the part of Congress to give laborers or materialmen a preferred status as to reserved funds. The statute sets up a machinery which purports to grant laborers and materialmen adequate protection. It cannot be denied that this statute supplies the means by which laborers and materialmen may be paid in full. The mere fact that the statute may, in certain cases, be administered inefficiently or that the contractor may be incompetent or wasteful affords no ground for the assumption that Congress intended in such cases that unpaid materialmen should have an equitable lien on funds due the contractor. The statute provides that a bond be given which is conditioned for the prompt payment of all persons supplying labor and materials. It does not follow that in cases where it turns out that the penal sum is insufficient to pay all such claimants in full that materialmen are given further and greater rights under the terms of the Act.

A study of the statute itself defeats any such conclusion. The statute provides: (40 U. S. C. A. Sec. 270):

> "* * * If the full amount of the liability of the surety on said bond is insufficient to pay the full amount of said claims and demands, then, after paying the full amount due the United States, the remainder (of the bond) shall be distributed pro rata among said interveners. * * * If the recovery on the bond should be inadequate to pay the amounts found due to all of said crediors, judgment shall be given to each creditor pro rata of the amount of the recovery. * * *"

These two provisions of the statute expressly show that Congress contemplated that situations would arise under the statute where the penalty of the bond would be insufficient to meet the claims of laborers and materialmen in full. If it was the purpose of Congress to give laborers and materialmen further protection, it would seem that the statute would have so provided. Further, congressional acquiesence in this language over a long period of time indicates that the statute was intended to give laborers and materialmen only such relief as is specifically provided for by it.

It is striking that, although the last session of Congress passed a law which supercedes and revises the previous statutes as to contractors' bonds and the rights of laborers and materialmen thereon, no attempt was made in the new statute to give materialmen a right to retained percentages. Nothing can be found in the new act which indicates that it ever was or is now the intent of the Congress to give materialmen a lien on reserved funds. (Public No. 321 74th Congress H. R. 8519, App. Aug. 24, 1935.) The failure of Congress to change the old statute in this respect clearly indicates that the Congress does not wish such a change.

Likewise the maxim *expressio unius est exclusio alterius* precludes the interpolation of any such meaning into the

statute. This is a settled rule of statutory construction and definitely prevents reading into the statute anything which its language does not import or comprehend.

We also know that it was the purpose of this statute to act as a substitute for the lien which the materialmen would ordinarily have if the contract did not involve public property. This statute was intended to give materialmen a type of security which would protect them and which would at the same time secure the Government of expeditious performance. It was not the purpose of the statute to create a lien on the funds of the contractor that might be in the hands of the Government and which might lead to troublesome litigation if such funds were diverted by the Government.

*Equitable Surety Co.* v. *United States*, 234 U. S. 448; 58 L. Ed. 1394 (1914);
*Hill* v. *American Surety Co.*, 200 U. S. 197, 203; 50 L. Ed. 437, 440 (1906);
*United States F. & G. Co.* v. *United States*, 191 U. S. 416; 48 L. Ed. 242 (1903).

The courts have frequently held that the Act of 1894 and similar state statutes do not create an equitable lien in favor of materialmen on reserved funds.

*American Surety Co.* v. *Finletter, supra;*
*Freeny* v. *Bauernschmidt*, 33 F. (2nd) 709 (C. C. A. 4th, 1929);
*Pratt Lumber Co.* v. *T. H. Gill Co., supra;*
*In re Fowble, supra;*
*Kellas* v. *Slack*, 129 Md. 535; 99 Atl. 677 (1916);
*Sexauer & Lemke* v. *Burke & Sons Co.*, 228 N. Y. 341; 127 N. E. 329 (1920);
*Robinson Mfg. Co.* v. *Blaylock, supra;*
*Southern Surety Co.* v. *Schlesniger, supra;*
See: *Hardaway* v. *National Surety Co., supra.*

The court had before it a case very similar to the present one in *In re Fowble, supra.* There the unpaid materialmen and the surety were competing for the balance of the contract price. The bond was given pursuant to a Maryland statute which is substantially the same as the Federal statute. There was no express provision in the bond requiring the contractor to pay materialmen. In like manner there is no promise on the part of the contractor in the case at bar to pay materialmen. The court held that the materialmen had no equitable lien on the reserved fund and were only entitled to claim as general creditors. In the course of his opinion Judge Rose said (p. 681):

> "The materialmen contend that in any event they had an equity in the fund superior to that of the trustee. Most men feel that one who has contributed to the creation of anything of value stands in a peculiar relation to it. He has a special claim to be paid out of it. The mechanic and other lien laws of so many jurisdictions are the expression of that conviction. The courts, however, have not seen their way clear to make it a generally applicable principle of equitable jurisprudence. It has had its part in shaping many a rule administered in chancery, but complete recognition has been withheld from it. The difficulty, in many, if not in most cases the impossibility, of accurately and justly defining its limits have amply justified the hesitation of the courts. If mechanic's lien laws prove the strength of its appeal to an instinctive sense of natural justice, they demonstrate that it is usually impossible to apply it beyond the limits to which the statutes go."

(3) *There is no basic reason for implying an equitable lien on the retained funds.*

The only remaining ground by which the respondents can contend that they have an equitable lien is that one should be implied. That equitable liens may arise *ex aequo*

*et bono* is not denied, but it by no means follows that the courts will apply this formula wherever it appears that as between two innocent parties one must suffer. In all cases where it is sought to invoke this doctrine of constructive liens, the courts weigh with meticulous care the equities of the respective claimants. Implied equitable liens are governed by fixed rules of law which must be respected and followed. Resort to the field of implication is at best a dangerous approach—such an approach usually presages a fundamental legal weakness in the case that can only be circumvented by invocation of this doctrine. It is not an "open sesame" or panacea for an otherwise insupportable cause of action.

There is no basis for implying an equitable lien on the reserved fund in the instant case. The contract between the Government and the contractor contains nothing which should cause an equitable lien to be implied. The contract does not state that the funds were to be retained for the benefit of materialmen or laborers. The contract negatives such a thought. The contract provides (R. 17):

> "In making such partial payments there shall be retained 10 per cent on the estimated amount until final completion and acceptance of all work covered by the contract: Provided, however, That the contracting officer, at any time after 50 per cent of the work has been completed, if he finds that satisfactory progress is being made, may make any of the remaining partial payments in full: And provided further, That on completion and acceptance of each separate building, vessel, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made in full, including retained percentages thereon, less authorized deductions."

This language conclusively shows that the funds were only to be retained "until final completion and acceptance"

of the project. The contract also states that when 50% of the work has been satisfactorily completed, the remaining payments may be made in full. If it had been the intent of the contracting parties that this fund be used to pay materialmen, the contract would not have provided that the funds be paid over to the contractor upon *completion* and *acceptance* of the work. This provision patently repudiates any inference that this fund was reserved to safeguard materialmen's claims.

The petitioner submits that when the language of the contract is considered there is no support for the statement that an equitable lien may be implied from the circumstances surrounding the contract between the contractor and the Government. Judge Sibley correctly analyzed the problem in his dissenting opinion when he said (R. 87):

> "* * * The only way to arrive at a lien for the materialmen that I can see is to assume that money retained by requirement of the contract is for the security of them also. This has not yet been authoritatively held, and because of the number of laborers and materialmen might prove embarrassing to Government in settling up contracts. The contract ought clearly to indicate such a purpose. The present contract does not. It contains no requirement that suppliers of labor and material be paid. The only reference in the contract to paying them is a provision that additional security on the bond protecting them can be required if the surety furnished should become unacceptable. The contract, like the statute, contemplates only the bond to secure them. The bond, of course, is conditioned to be void if the contractor fully performs the contract and in addition pays promptly all persons supplying labor and materials. If the contractor fails to pay any of them the surety must pay up to the penalty of his bond, but that is all. This it has done, and the bond and all its obligations are satisfied. * * *"

The opinion of the court in *In re Scofield*, 215 Fed. 45 (C. C. A. 2d, 1914) is also very helpful. The court said (p. 48):

> "There is nothing in this record to indicate that the United States withheld the reserved percentages for the benefit of the subcontractors, unless such intention can be inferred from the language of the bond, which made it the duty of the contractor to pay promptly the subcontractors. The contract itself, in providing for withholding the percentages, does not state or explain the reason, at least so far as this record shows. It simply states that they may be withheld 'until the final completion and acceptance of the work'. This might seem to indicate that the purpose was simply to secure the government in case the work was not prosecuted promptly and faithfully, for the contract expressly provided that if for any of the reasons stated in the contract the United States found it necessary to terminate the contract, then it might deduct from the reserved percentages which it had withheld whatever sums it expended in completing the contract in excess of the stipulated price, and it allowed certain other deductions to be made. And there was no authority given to pay any subcontractors or deduct from the reserved fund any sums paid to any such persons. Nevertheless when the contract is construed in its entirety and in connection with the obligations imposed by the bond, it will be found that an equity was created in favor of the surety in the reserved fund to which it is the duty of this court to give effect."

Pretermitting the contract, there is no essential equity in the materialmen which would demand that an equitable lien be appended to the reserved fund. It seems peculiar that if the materialmen placed as much reliance on the reserved fund in making their respective sales to the contractor as they now assert, that they did not take the proper

steps to make certain that this fund would be used for their benefit. It was perfectly competent for the materialmen to contract with the Surety and the contractor for such a lien, or to decline to furnish in the absence of such security. The Surety took proper steps to insure itself that it would have the protection of this fund. We respectfully suggest that this Surety should not be penalized because it chose by legitimate means to safeguard itself from loss. Nor should a court of equity be more zealous to create or protect materialmen's rights than were the materialmen themselves.

It is reasonable to conclude that in dealing with the contractor the materialmen relied wholly upon the penalty of the bond and the contractor's financial stability. Furthermore, the respondents had notice of the Surety's rights in the fund before they extended any credit to the contractor. That notice may have been actual or constructive. The bond was required by statute. The respondents cannot claim ignorance of the law. The materialmen were thereby put on notice that there was a surety and were therefore bound to inquire as to the terms of the suretyship relation. Such inquiry would have disclosed that the surety was bound to pay laborers and materialmen to the extent of $3940; that a certain percentage of the contract price was reserved; and that the surety had an interest in all unpaid moneys owing the contractor.

The materialmen should have the same notice of the surety's relationship as have assignee banks. In one case the transaction takes place solely between the contractor and materialmen, and in the other between the contractor and the bank. No principle of law or equity says that materialmen may exercise less care and caution in dealing with the contractor than is required of an assignee bank. Nor does any rule of law guarantee that if materialmen take no steps to protect themselves in such dealings an

equitable lien will arise to protect them. The courts have ofttimes held that an assignee bank has no superior right to the reserved fund as against a surety for the reason, among others, that the bank has notice of the surety's rights in the fund.

*New Amsterdam Casualty Co.* v. *City of Astoria, supra;*

*American Bank & Trust Co.* v. *Langston,* 180 Ark. 643; 22 S. W. (2d) 381 (1929);

*Wasco County* v. *New England E. Ins. Co., supra;*

*Derby* v. *United States F. & G. Co.,* 87 Oreg. 34; 169 Pac. 500 (1917).

In *New Amsterdam Casualty Co.* v. *City of Astoria, supra,* the court said (p. 563):

> "'• • • the contracts being for the prosecuting of public work, persons taking assignments from the contractor of funds to be disbursed in final payments are bound to take notice, first, of the terms of the contract; second, that the contract is accompanied by the bond of a surety, and likewise of the undertaking of the surety; and, third, that the reserve fund is for the indemnity of the surety as well as that of the city. This subordinates the claims of the assignees of parts of the funds to become due to the demands of the surety."

When all of these factors are taken into account, we may well question the soundness of the suggestion that this court should create a lien purely on the basis of implication. This court is now asked to upset or ignore certain rights which have been purchased by the Surety for a valid consideration. These rights were not obtained fraudulently or by means of an act of bankruptcy—they were acquired legitimately. We submit that there are no circumstances

in the case which should cause a court of equity to imply an equitable lien on behalf of materialmen.

Finally, it should be observed that even if an equitable lien were implied in favor of the materialmen, the equitable lien which the petitioner has on the fund is superior and should take precedence since it arises from an express contract and since it was prior in time. The equitable lien of the materialmen, if there be such, can only be the product of implication or, as Judge Sibley said, of "judicial legislation." If there be any fallacy in a law which fails to give the materialmen complete protection in every case, the error is one which should be corrected by the Congress and not by the courts. The materialmen can also safeguard themselves if they so desire by making appropriate contracts for that purpose.

(4) *A discretionary retention of funds does not establish an equitable lien for the materialmen on such funds.*

A discretionary power to retain a part of the contract price creates no equitable lien on the funds retained. If an equitable lien is to be settled upon a reserved fund, the right to withhold such a fund must be absolute.

*Kane, Trustee* v. *First National Bank*, 56 Fed. (2nd) 534 (C. C. A. 5th, 1932).

*Alfred Richards Brick Co.* v. *Rothwell, supra.*

In the case at bar the contract between the Government and the contractor provides that 10% of the contract price may be held back pending "final completion and acceptance" of the project. The project was completed and accepted long before the funds in question were paid into court. The retention of those funds by the Government after the completion and acceptance of the work was not authorized by the contract. The best that can be said for this conduct is that the Government had a discretionary right to hold back those

funds. This discretionary retention created no equitable lien for the materialmen on the funds.

The respondents may reply that their equitable lien, assuming that they have one, had attached to the funds prior to the completion of the contract. Even if this be true, that lien was lost when the absolute right on the part of the Government to retain those funds terminated. The materialmen's lien, if any, must be co-extensive with the unrestricted power of the Government to keep back those funds. They certainly have no greater right.

However, if it be assumed that they have a right which was affixed to the funds prior to the completion of the contract, the materialmen would have no lien on the entire $2,775.25 now in court. They can only have an equitable lien, if at all, on $762 of that amount. Since 10% of the contract price is $1,524, and since the Government only had an unqualified right to withhold 10% of the estimates until 50% of the work was satisfactorily completed, it would follow that the Government, under the terms of the contract, had an absolute right to retain only 50% of $1,524 or $762. All other funds which were retained were based on the Government's discretionary power and can constitute no foundation for an equitable lien (Judge Sibley's dissenting opinion, R. 88).

## Point III.

**If the Surety is Denied a Preferred Claim, It, Nevertheless, Has a General Creditors Claim and Would Share Ratably With the Materialmen and Other General Creditors.**

If this Court should be of the opinion that the Surety has no prior equity in the fund, the Surety is certainly entitled to participate *pro rata* with the materialmen and other general creditors in the distribution of the present fund. It has been previously shown that the materialmen are only general creditors of the contractor. (Point II, p. 31, *supra*).

The decision of the Court of Appeals giving materialmen priority over the Surety is not consistent with the great weight of authority.

*Mellette Farmers El. Co.* v. *H. Poehler Co.*, *supra.*

*United States F. & G. Co.* v. *Centropolis Bank*, *supra.*

*In re McGarry & Son*, 240 Fed. 400 (C. C. A. 7th, 1917).

*Southern Surety Co.* v. *Merchants & Farmers Bank*, 203 Ind. 173, 195, 176 N. E. 846 (1931).

*Cole* v. *Myers*, 100 Nebr. 480; 160 N. W. 894 (1916).

In view of these authorities it is clear, we submit, that the Court of Appeals was in error in completely subordinating the rights of the Surety to those of the materialmen.

**Conclusion.**

Since it has been shown that the Surety has a direct right to the fund; that it has a claim to the fund on principles analagous to those of subrogation; that the materialmen have no equitable lien on or preferred claim to the fund, it is submitted that the Surety is entitled to the entire amount of the reserved fund.

Respectfully submitted,

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## APPENDIX.

### The Statute Involved.

*Title 40, Sec. 270, of United States Code Annotated.*

§ 270. Bonds of contractors for public buildings or works; rights of persons furnishing labor and materials. Any person or persons entering into a formal contract with the United States for the construction of any public building, or the prosecution and completion of any public work, or for repairs upon any public building or public work, shall be required. before commencing such wark, to execute the usual penal bond, with good and sufficient sureties, with the additional obligation that such contractor or contractors shall promptly make payments to all persons supplying him or them with labor and materials in the prosecution of the work provided for in such contract; and any person, company, or corporation who has furnished labor or materials used in the construction or repair of any public building or public work, and payment for which has not been made, shall have the right to intervene and be made a party to any action instituted by the United States on the bond of the contractor, and to have their rights and claims adjudicated in such action and judgment rendered thereon, subject, however, to the priority of the claim and judgment of the United States. If the full amount of the liability of the surety on said bond is insufficient to pay the full amount of said claims and demands, then, after paying the full amount due the United States, the remainder shall be distributed pro rata among said interveners. If no suit should be brought by the United States within six months from the completion and final settlement of said contract, then the person or persons supplying the contractor with labor and materials shall, upon application therefor, and furnishing affidavit to the department under the direction of which said work has been prosecuted that labor or materials for the prosecution of such work has been supplied by him or them, and payment for which has not been made, be furnished with a certified copy of said contract and bond,

upon which he or they shall have a right of action, and shall be, and are hereby, authorized to bring suit in the name of the United States in the district court of the United States in the district in which said contract was to be performed and executed, irrespective of the amount in controversy in such suit, and not elsewhere, for his or their use and benefit, against said contractor and his sureties, and to prosecute the same to final judgment and execution: *Provided*, That where suit is instituted by any of such creditors on the bond of the contractor it shall not be commenced until after the complete performance of said contract and final settlement thereof, and shall be commenced within one year after the performance and final settlement of said contract, and not later: *And provided further*, That where suit is so instituted by a creditor or by creditors, only one action shall be brought, and any creditor may file his claim in such action and be made party thereto within one year from the completion of the work under said contract, and not later. If the recovery on the bond should be inadequate to pay the amounts found due to all of said creditors, judgment shall be given to each creditor pro rata of the amount of the recovery. The surety on said bond may pay into court, for distribution among said claimants and creditors, the full amount of the sureties' liability, to wit, the penalty named in the bond, less any amount which said surety may have had to pay to the United States by reason of the execution of said bond, and upon so doing the surety will be relieved from further liability: *Provided further*, That in all suits instituted under the provisions of this section such personal notice of the pendency of such suits, informing them of their right to intervene as the court may order, shall be given to all known creditors, and in addition thereto notice of publication in some newspaper of general circulation, published in the State or town where the contract is being performed, for at least three successive weeks, the last publication to be at least three months before the time limited therefor. (Aug. 13, 1894, c. 280, 28 Stat. 278; Feb. 24, 1905, c. 778, 33 Stat. 811; Mar. 3, 1911, c. 231, § 291, 36 Stat. 1167.)

(6889-C)